THE TRUST FUND THEORY AND SOME SUBSTITUTES FOR IT.

It was formerly supposed that the relations between a corporation and its creditors were the same as those which existed between an individual debtor and his creditor. For example, in the year 1826, in the case of *Catlin v. The Eagle Bank* (6 Conn. 233), Chief Justice Hosmer said:

> "Where no legal lien has been obtained, it is a reasonable supposition that the relation between creditor and debtor must in all cases infer the same consequences; and that where the same mischief exists, there is the same law. The cases of an individual and of a corporation, in the matter under discussion, it appears to me are not merely analogous but identical; and I discern no reason for the slightest difference between them."

Since that time, however, the view has gradually grown up that the common law rights of a creditor over his debtor's property did not adequately protect the creditor of a corporation. In order to give the latter more extensive rights, it was thought that those rights must be based upon a theory different from that which ordinarily applies between debtor and creditor.

This new doctrine was for the first time announced in the year 1824 by Judge Story in the well-known case of *Wood v. Dummer* (3 Mason 309). In that case, the stockholders of a bank without paying its debts, had divided among themselves all the property of the corporation. Manifestly, a great injustice had been done to the creditors and on some theory or other they must be allowed to recover their claims from the persons who had so received the property of the corporation. Apparently, Judge Story thought that none of the principles of law applicable to the ordinary relation of debtor and creditor were adequate to the situation. The stockholders did not owe the debt and how, therefore, could the creditor compel them to pay? If, however, the property of the company be regarded as a fund held by the corporation in trust for its creditors, then the difficulty was overcome, for trust property could be

followed into the hands of persons who have notice of the trust. As Judge Story said:

> "If I am right in this position, the principle difficulty in the cause is overcome. If the capital stock is a trust fund, then it may be followed into the hands of any persons having notice of the trust attaching to it."

As this new theory was so convenient to the solution of this case, Judge Story proceeded to show that the property of a corporation was a fund held in trust by it for its creditors. He says:

> "It appears to me very clear upon general principles as well as the Legislative intention, that the capital stock is to be deemed a pledge or trust fund for payment of debts contracted by the bank. The public as well as the Legislature have always supposed this to be a fund appropriated for such a purpose. The individual stockholders are not liable for the debts of the bank in their private capacities. The charter relieves them from personal responsibility and substitutes the capital stock in its stead. Credit is universally given to this fund by the public as the only means of repayment. * * * The stockholders have no rights until all the other creditors are satisfied. They have the full benefit of all the profits made by the establishment, and cannot take any portion of the fund until all the other claims on it are extinguished."

There would perhaps be little reason to object to calling the property of a corporation a trust fund for the benefit of its creditors, if all that the phrase meant was, that a corporation must pay its debts before dividing its assets among its stockholders.

But the trouble is that the "trust fund theory" thus originated has not been confined to the case to which Judge Story first applied it. That could not be expected. The consequences of the theory as applied to other cases are at once pressed upon the courts. It is at once argued that if the property of a corporation is a fund held by it in trust for its creditors, then all the principles of the law of trusts and trustees apply; and soon the rights of the creditor of a corporation over his debtor's property become entirely different and much more extensive than his rights over the property of an individual.

Hence, it becomes desirable to determine whether property of a corporation under any circumstances is, in any proper sense of the term, a trust fund held by it for the benefit of its creditors.

The reasons advanced by Judge Story and repeated by many judges since that time furnish perhaps a ground for adopting a different *policy* toward a corporation than toward an individual debtor; but they furnish no ground for applying to corporate property the law of trusts and trustees. The facts that the stockholders are relieved from liability and that creditors look to the property of a corporation for the payment of their debts are not sufficient to bring the case within the settled definition of a trust.

A trust implies a trustee holding a legal title and cestui que trusts who have the beneficial interest. A court of equity will compel a trustee to hold and manage the property for the sole benefit of a cestui, to whom alone, in its eyes, the property belongs. The trustee can make no profit out of the property. His sole reward is his commission. All the property and all the profits belong to the cestui que trust.

Manifestly, the property of a corporation is held by it in trust in no such sense. A corporation has the beneficial or equitable as well as the legal title. It is in business to make money for itself and its stockholders and not for its creditors; while a trustee can only make money for his cestui que trust.

But it may be said that it is not claimed that the property of a going, solvent corporation is a trust fund for its creditors; it is only when the corporation becomes insolvent and ceases to do business that the assets become a trust fund. Many cases may be found where it is so stated. For example, in the case of *Appleton v. Turnbull* (84 Me. 72), the court said:

> "It is too firmly established at the present day to be questioned, that the capital stock of a corporation is a trust fund for the payment of its debts * * * during the existence of the life of the corporation, it is a trust to be managed for the benefit of its stockholders, but in the event of a dissolution or of insolvency, it becomes a trust fund for the benefit of its creditors."

This doctrine is equally objectionable with the doctrine first stated. The assets of an insolvent corporation which has ceased to do business are in no proper sense held by the corporation in trust for its creditors.

It is true, undoubtedly, that the creditors are entitled to have all the property applied to the payment of debts. The same, however, is true of an insolvent individual. But the fact of insolvency does not make either the property of an individual or that of a corporation a trust fund for creditors. Creditors may levy executions on such

property, but they have no equitable title to it. The fact of insolvency alone does not give a court of equity jurisdiction to manage and administer the property as a trust estate. The mere insolvency of a corporation even coupled with cessation of business has never been considered as ground for the appointment of a receiver on the application of a creditor, unless so provided by statute. Nor can this case be brought within any of the classes of trusts which courts of equity are accustomed to enforce.

In short, whether before or after insolvency, a corporation has the entire title, both legal and equitable. There is no principle of law which will vest an equitable title in one where there was none before, because of the single fact of insolvency.

No extended argument seems necessary to prove that this is a correct statement of the law. Such an argument may be found, however, in the case of *O'Bear Jewelry Co. v. Volfer* (106 Ala. 205), where in the course of an opinion, in which the trust fund theory is repudiated, the nature of a trust and the modes in which one may come into existence are fully considered and the conclusion reached that the property of a corporation is not held by it in trust for creditors.

Not only has this conclusion been reached in jurisdictions which have repudiated the theory, but other courts which at times have strongly insisted upon the doctrine, have refused to accept its consequences. While insisting on the name, they have in effect held that corporate property was not trust property. The decisions of the United States Court, in which the doctrine originated, well illustrate this.

In *Sawyer v. Hoag* (17 Wall. 610) and *Upton v. Tribilcock* (91 U. S. 45), and in other cases, the Supreme Court seemed to have fully adopted the new principle announced in *Wood v. Dummer* (supra). The property of a corporation was to be regarded as trust property, certainly so in the event of insolvency. At a time when it seemed that this must be considered as too firmly established to be overthrown, the case of *Graham v. R. Co.* (102 U. S. 148) came before that court.

That was a suit by a subsequent creditor, who had obtained a judgment, to reach property which had been conveyed by the corporation to its directors. It was contended that:

> "A corporation debtor does not stand on the same footing as an individual debtor; that, whilst the latter has supreme dominion over his own property, a corporation is a mere trustee, holding its property for the benefit of its

> stockholders and creditors; and that if it fail to pursue its rights against third persons, whether arising out of fraud or otherwise, it is a breach of trust, and creditors may come into equity to compel an enforcement of the corporate duty."

In *Wabash etc. R. Co. v. Ham* (114 U. S. 587), a similar case, four corporations had been consolidated and their property conveyed to a new corporation, which had subsequently mortgaged it. The plaintiff was an unsecured contract creditor of one of the old companies and sued to have his debt declared a lien on the property of the new company, superior to the mortgage. It was contended that the property of the old corporation was a trust fund for creditors and therefore the plaintiff had an equitable lien upon it.

If the property of a corporation is to be considered a trust fund for creditors as the Supreme Court had repeatedly declared, then it would seem that both these cases should have been decided in favor of the plaintiff. Indeed the same court had said in *Sawyer v. Upton* (91 U. S. 56) that "the creditors have a lien upon it (the corporate property) in equity."

In each of the above cases, however, the court refused to accept the consequences of the doctrine which it had in the beginning so eagerly welcomed.

In the *Graham* case, the court said:

> "A corporation is a distinct entity. Its affairs are necessarily managed by officers and agents, it is true; but, it is as distinct a being as an individual is, and is entitled to hold property (if not contrary to its charter) as absolutely as an individual can hold it. Its estate is the same, its interest is the same, its possession is the same."

And in the *Wabash R. R. Co.* case, the court held that all that the trust fund doctrine meant was that when a corporation becomes insolvent "all its creditors are entitled in equity to have their debts paid out of the corporate property before any distribution is made among stockholders."

To the same effect see *Fogg v. Blair* (133 U. S. 534).

Thus the court, while still insisting on the name, in effect, says that there is in such a case no trust; for manifestly, a right to have a debtor's property applied to the payment of debts before being used for his own purposes does not make the debtor a trustee, or the creditor a cestui que trust.

But it may be said that in the above cases the corporation was not insolvent and therefore the court was acting within the princi-

ples which it had previously laid down when it decided that the principles of the law of trusts were not applicable to the property of a solvent corporation.

This is perhaps true. But in the subsequent case of *Hollins v. The Brierfield Coal & Iron Co.* (150 U. S. 371) the same court refused to apply the law of trusts to the property of an insolvent corporation. In that case, unsecured contract creditors, without first reducing their claim to a judgment, filed a bill against a corporation asking for the appointment of a receiver and the administration of the corporate property by the court for the benefit of the creditors. In answer to the objection that only judgment creditors or those having an express lien were entitled to pursue such a remedy, it was contended that the corporate assets constituted a trust fund for creditors and hence a court of equity could administer this for the benefit of the cestui que trust.

The court said:

> "A party may deal with a corporation, in respect to its property, in the same manner as with an individual owner, and with no greater danger of being held to have received into his possession property burdened with a trust or lien. The officers of a corporation act in a fiduciary capacity in respect to its property in their hands, and may be called to an account for fraud, or sometimes even mere mismanagement, in respect thereto; but, as between itself and its creditors, the corporation is simply a debtor, and does not hold its property in trust, or subject to a lien in their favor, in any other sense than does an individual debtor."

And again:

> "It is rather a trust in the administration of the assets after possession by a court of equity, than a trust attaching to the property, as such, for the direct benefit of either creditor or stockholder."

The doctrine of the United States Court is well summed up in the recent case of *The American Exchange Bank v. Ward* (111 Fed. 782), where the court said:

> "The only trust attaching to such property is in the administration of the assets after possession is taken by a Court of Equity and is not a trust attaching to the property as such for the direct benefit of either creditor or stockholder."

The Supreme Court, however, still insists on using the term "trust fund," though it has refused to apply the law of trusts to the property of either an insolvent or solvent corporation.

See *Camden v. Stuart* (144 U. S. 104).

The reason for this seems to be partly because of reluctance expressly to overrule some of the earlier cases, where the theory was vigorously asserted, and partly because the court wishes still to apply some of the principles of the law of trusts while refusing to apply others. It still deems the principle of following trust property which was applied in *Wood v. Dummer* essential in order to enable a court of equity to do full justice to creditors of corporations.

But what are the rights of a creditor of a corporation if the trust fund theory must be abandoned as having no foundation in the law?

This question can be best answered by considering some of the cases to which the theory has been applied.

The principle cases, perhaps, to which the doctrine has been applied, are the following:

1. Where the property of a corporation has been divided among its stockholders without paying creditors.

2. Where an insolvent corporation has preferred a creditor.

3. Where it is sought to recover unpaid or partially paid subscriptions to capital stock.

1. The first of the cases enumerated, to wit: Where a corporation has distributed its property among its stockholders without having first paid its debts, is the case of *Wood v Dummer* (supra), in which this doctrine, as has already been stated, was originated. It is simply a case of a debtor giving away his property so that nothing is left with which to pay his debts. Such acts, of course, were long ago forbidden by the law as being conveyances in fraud of creditors. There is no reason why the ordinary remedies of a creditor to pursue property fraudulently conveyed should be considered insufficient. A judgment creditor's bill will lie. If it were the case of a breach of trust, the cestui que trust could follow the trust property without first obtaining a judgment against the trustee; but in the case under consideration, the creditor must first exhaust his legal remedies against the corporation before pursuing his equitable remedies against persons who have received its property, thus standing on exactly the same footing that creditors of individuals do.

Hollins v. Brierfield Coal Company (supra).

This seems to be the real ground of the rule that corporate debts must be paid before any distribution is made among stockholders. If any further ground for the rule is thought necessary, it may be found in the analogy to the law of partnership, which requires firm

debts to be paid out of the assets before individual debts. Moreover, the rule seems to be a legitimate conclusion to be drawn from the argument of Judge Story quoted above.

2. In the second case above referred to, the trust fund theory has been used to prevent a corporation from preferring a creditor under circumstances where an individual debtor would have the right to make such a preference. The argument is perfectly logical. If the property of an insolvent corporation is a trust fund for creditors, if in equity all the property belongs to them in proportion to their debts, a preference of one of such creditors is a breach of trust. A portion of the property which one creditor gets by the payment of his debt in full, belongs in equity to the other creditors.

This is the position taken in *Rouse v. Merchants Bank* (46 Ohio St. 493), where the court says:

> "It being established that the corporate property is a trust fund for the benefit of corporate creditors, it follows that after the insolvency of the company is ascertained and the objects of its creation are no longer pursued, the managing board of directors then having the custody of the property become trustees thereof for the creditors and this relation necessarily forbids any discrimination between the beneficiaries of the distribution or application of the funds."

The common law rule that a debtor in failing circumstances may prefer any creditor he chooses has often been criticised, but is as fully established as any principle of the common law. If, as we have seen, the trust fund theory has no basis in the law of trusts, then the reason for refusing to allow a corporation to prefer a creditor necessarily fails. Under the trust fund theory as finally interpreted by the U. S. Supreme Court, the same conclusions must follow. If, as stated in *Fogg v. Blair,* the doctrine only means that creditors must be paid before any distribution is made among stockholders, or if, as stated in the *Hollins* case, the doctrine means that the corporate property, when taken possession of by a court of equity, will be administered as if it were trust property, then the same conclusion is reached. Neither of these principles furnishes any ground for refusing to apply the common law rule which allows debtors to make preferences among their creditors. Indeed, the Supreme Court so intimated in the case of *Smith Purifier Co. v. McGroarty* (136 U. S. 237-241), where it is said that the Ohio decisions proceed upon "a theory that the property of an insolvent corporation is a trust fund in a wider and more general sense than could be maintained upon general principles of equity jurisprudence."

See also *Sandford F. & T. Co. v. Howe, etc., Co.* (157 U. S. 312).

The conclusion is that there is no principle of the common law which prevents an insolvent corporation from making preferences among creditors, just as an individual may do. If public policy requires that it should be forbidden, it is a matter for statutory regulation. Those courts which have acted on the theory of the Ohio court are guilty of judicial legislation.

Probably in a majority of the states preferences by corporations are permitted. For example in *Pond v. Framingham & Lowell R. Co.* (130 Mass. 194), the Massachusetts courts held that the rights of the parties were governed by the common law and refused to enjoin an insolvent corporation from making preferences.

In *First National Bank v. Dovetail Co.* (143 Ind. 550), the Indiana courts followed the rule of the *Hollins* case and held that an insolvent corporation had the same power as an individual over its property, until the court by its officers took possession of it.

In *Brown v. Grand Rapids Co.* (22 L. R. A. 817), the Michigan courts held that the assets of an insolvent corporation were not trust funds for equal distribution among creditors.

So also the Missouri courts in *Schufeldt v. Smith* (29 L. R. A. 830), decided that no argument against preferences could be based on the trust fund theory, as that theory "while dominion over its property is retained is not recognized as being sound."

In Connecticut, Judge Hosmer in the early case of *Catlin v. Eagle Bank,* already cited, reached the same conclusion. That case is especially interesting because in it that eminent judge repudiated the trust fund theory within two years after *Wood v. Dummer* had been decided. The reasoning of that case is in no degree shaken by the subsequent decision in *Crandall v. Lincoln* (52 Conn. 73), in which the court said with reference to the *Catlin* case:

> "We cannot believe that the court intended to establish a rule which should be contrary to the overwhelming current of authorities in nearly every other jurisdiction."

The absurdity of this statement becomes manifest when it is remembered that *Wood v. Dummer* was at the time when Judge Hosmer wrote probably the only decision sustaining the trust fund theory. If the *Catlin* case is contrary to the "current of authority," it is because since that time some jurisdictions have chosen to follow new gods instead of worshipping at the shrine of the old ones.

These courts in refusing to accept a logical consequence of the trust fund theory, repudiate it.

3. The trust fund theory has been, perhaps, most often applied to the case where a creditor of an insolvent corporation seeks to compel a stockholder to pay a balance claimed to be due on stock for which the par value has never been paid to the corporation.

Cases where creditors seek to recover a balance claimed to be due on stock may be considered in two classes.

(a) Cases where the stockholder has subscribed for the stock at par.

(b) Cases where the corporation has issued stock as full paid, under an agreement with the stockholder that he shall pay nothing or less than par.

The first class presents no difficulty. The application of ancient and familiar principles of law enables creditors to recover such subscriptions.

The contract of a subscriber to stock as construed in most jurisdictions is to pay the par value when called upon by the company and if the company becomes insolvent, to pay any balance up to the par value if needed to pay creditors.

Scoville v. Thayer (105 U. S. 143); *Fish v. Smith* (73 Conn. 377).

If such a claim has become fully matured by a call on the part of the directors; a creditor of the corporation may garnishee the stockholder or pursue any other remedy just as if his debtor were an individual. If the directors have made no call, probably such subscription could not be collected by the creditor in a suit at law; but it could be reached through the aid of a court of equity and a receiver. In either case there is no occasion for the application of any principle different from that which is ordinarily applied between debtor and creditor, or in other words, there is no occasion for applying the trust fund theory.

The courts have often strained the facts in order to bring cases within this class. It is often said, as for example in *Upton v. Tribilcock* (91 U. S. 45), that "a promise to take shares of stock imports a promise to pay for them." This is undoubtedly a fair inference of fact drawn from the fact of subscription and customs of business. But where there is an express agreement by which the exact amount to be paid is fixed, there would seem to be no room for such inference. For instance, in the above case, there was clearly a definite understanding between the agent of the corporation and the stockholder that only 20 per cent. of the par value should be paid. It was therefore impossible to infer from the taking of the stock an agreement to pay par for it. On the facts no court would have

allowed the corporation itself to recover from the stockholder beyond the 20 per cent. The court has made a bargain for the parties instead of enforcing their contract as made by them.

Nevertheless, that case and others like it, if the facts can bear the construction put upon them, did not require the application of the trust fund theory, for they fall in the class now under consideration.

The second class mentioned above presents a more difficult question. There it is admitted that the stockholder never agreed to pay the balance which it sought to recover from him and that the corporation itself could not have recovered it, because the stock was issued as a gift or under an express agreement to pay a sum less than par. *Scoville v. Thayer* (105 U. S. 143) was such a case, the first of the kind which arose in the Supreme Court. It was said:

> "The stock held by the defendant was evidenced by a certificate of full paid shares. It is conceded to have been the contract between him and the company that he should never be called upon to pay any further amounts upon it. As between him and the company, this was a perfectly valid agreement. * * * No suit could have been maintained by the company to collect the unpaid stock. The shares were issued as full paid on a fair understanding and that bound the company."

The question then arises whether there is any principle of law which will allow creditors of the company to recover in such a case though the corporation could not.

The answer given to this question by the trust fund theory is that the stockholder should pay because he has received trust property.

In the first place, it should be noticed that in order to apply the theory of trusts to this case, it must be held that the stock of a corporation is a trust fund whether the corporation is solvent or insolvent, for in most cases, the act which is claimed to be a breach of trust, to wit: issuing stock at less than par or as a bonus, was done while the company was a solvent going concern. Some of the cases go to this extent. For example: In *Union National Bank v. Douglass* (1 McCrary 86), the court said:

> "The truth is that it makes no difference whatever whether a corporation is solvent or insolvent, so far as the doctrine is concerned, that the property is a trust fund which cannot be withdrawn or appropriated by the stockholders until the debt is paid."

This is in direct conflict with the very many cases where it is said that the property is a trust fund only when the company becomes insolvent. In the present case, in order to make the theory apply, it is necessary to call the property of a *solvent* corporation trust property. In those cases, in order to relieve the court of the consequences of calling such property trust property, the court has denied that it was such until the corporation became insolvent. Such is the inconsistency to which the doctrine leads.

In the next place, it may be inquired, what trust property has the stockholder received for which he is accountable to a creditor? If we suppose that a corporation, newly organized, and without property, issues to certain persons all its stock, there is certainly no ground at that point of time for saying that such persons have received any property, trust or otherwise, of the corporation. The corporation had nothing. The stock would necessarily be worthless. Or suppose that an existing corporation, already having stockholders, issues additional stock to outside parties without consideration. Has not the corporation just as much property as before, and has any existing creditor any reason to complain? Clearly, in such a case, the situation of the creditor is in no wise changed. It is the former stockholders who are injured. This has been repeatedly noticed in the cases.

See *Flinn v. Bagley,* 7 Fed. 841; *Coit v. Gold Amalgamating Co.,* 119 U. S. 343.

In fact, as stated in *Flinn v. Bagley,* if anything at all was paid for the stock, existing creditors instead of being injured are better off than before.

The fact is that unissued stock is in no sense property of the corporation and cannot therefore constitute a trust fund. Until issued it is a mere possibility, like a contract while negotiations are still in progress. The corporation has the power to issue stock but has not yet done so. If stock is issued without consideration, the corporation has parted with no property. It has neither more nor less than before. The ownership of the corporation merely has been subdivided. Partners may take in an additional partner and give him an interest in the firm assets without consideration. Such action would, however, not decrease the property of the firm, but would affect the division of the profits. So in the case of a corporation, the issue of bonus stock affects the amount of dividends which each stockholder may receive and not the amount of the property of the corporation. If any injury is done. therefore, it is to non-consenting stockholders and not to existing creditors.

The necessary conclusion is that a stockholder cannot be made to respond to creditors on the ground that he has received property which constituted a trust fund for their benefit, for he has received no property of the corporation.

It is true that the stock issued without consideration may be of great value to the holder, but it is not because he has received any property of the corporation, but because the original stockholders have permitted him to gain a right to a share in profits and management which they might have kept themselves or compelled the person acquiring it to pay for. Creditors could in no way have realized upon the unissued stock. Why should they have greater rights when it is issued? The property of the corporation is one thing; the right to manage and participate in profits is another. The one is owned by the corporation; the other by the stockholders, and can never be owned by the corporation.

The same line of argument, of course, will apply to future creditors. There can be no breach of trust as to them because the corporation has parted with no property held by it in trust or otherwise.

Hitherto, the question has been considered on the basis that the ground on which the cases which hold that stockholders may be compelled to pay more for their stock than they agreed to pay, rest, is, that the unissued stock of a corporation is in a strict sense a trust fund, as the name indicates. But, if the reasons given in some of the cases for the conclusion, be considered, it will be seen that this theory is not the real ground of the decision. For example, in *Scoville v. Thayer* (supra) the court said:

> "The reason is that the stock subscribed is considered in equity as a trust fund for the payment of creditors. It is so held out to the public who have no means of knowing the private contracts made between the corporation and its stockholders. The creditor has the right, therefore, to presume that the stock subscribed has been or will be paid up."

The real ground of the decision is that it is held out to the public that stock issued has been or will be paid up and that persons dealing with the corporation, who have no means of knowing the private contracts between the corporation and the stockholder have a right to rely on the representations.

Regarding this as the real ground on which the court intended to place the decision, certain conclusions follow. No one except persons who were so misled could have any claim against a stockholder on this ground. Creditors existing at the time when the

unpaid stock of the corporation was issued as full paid could not have been misled nor could persons who became creditors subsequent to that time, if they knew the actual contract under which the stock was issued.

It was so decided in *Coit v. Gold Amalgamating Co.* (119 U. S. 343) and *Handley v. Stutz* (139 U. S. 417). In the latter case it was held that those only, who had "trusted the company upon the faith of the increased stock," were entitled to enforce their claims against the stockholders.

The essential features of the creditors' claim according to these cases seem to be a holding out on the part of the corporation or stockholder that stock issued is either full paid or will be and an extension of credit to the company on the faith of such representations, i.e. by a subsequent creditor ignorant of the actual contract on which the stock was issued.

Now it is apparent that there is nothing in this state of facts which can be said to constitute the relation of trustee and cestui que trust between the corporation and its creditor. To call the theory on which a creditor is allowed to recover in such a case a trust fund theory is a manifest misnomer.

Such a state of facts calls for the application of the principles of law relating to fraud or estoppel rather than the principles of law relating to trusts. For this reason, it seems to be the present tendency of the courts to abandon the term "trust fund" and to adopt fraud as the ground for recovery. One of the first cases in which the decision is put upon that ground is *Hospes v. Car Co.* (48 Minn. 174) decided in 1892. It that case, after pointing out that creditors cannot recover against a stockholder on the ground of contract, where the corporation could not, because where there is an express contract to pay less than par, the court has no power to infer a contract to pay par, and after referring to the cases which hold that only creditors who trusted the company on the faith of the unpaid stock can recover against stockholders, the court reaches the conclusion that the true ground of recovery is fraud.

> "The capital of a corporation is the basis of its credit. It is a substitute for the individual liability to those who own its stock. People deal with it and give it credit on the faith of it. They have the right to assume that it has paid in capital to the amount which it represents itself as having; and if they give it credit on the faith of that representation, and if the representation is false, it is a fraud upon them; and, in case the corporation becomes

> insolvent, the law, upon the plainest principles of common justice says to the delinquent stockholder, 'Make that representation good by paying for your stock.' It certainly cannot require the invention of any new doctrine in order to enforce so familiar a rule of equity. It is the misrepresentation of fact in stating the amount of capital to be greater than it really is that is the true basis of the liability of the stockholder in such cases; and it follows that it is only those creditors who have relied, or who can fairly be presumed to have relied, upon the professed amount of capital, in whose favor the law will recognize and enforce an equity against the holders of "bonus" stock. This furnishes a rational and uniform rule, to which familiar principles are easily applied, and which frees the subject from many of the difficulties and apparent inconsistencies into which the "trust fund" doctrine has involved it; and we think that, even when the trust-fund doctrine has been invoked the decision in almost every well-considered case is readily referable to such rule."

Before proceeding farther, it may be well to note some of the consequences of putting the cause of action on this basis. One necessary result is that no person, whose claim is in tort, except the defrauded creditor, could recover against such a holder of unpaid stock. His claim did not arise on the faith of the unpaid stock and could not have done so.

Another consequence of the doctrine is that the creditors claim is a personal one against the stockholder who has defrauded him. It would seem that his rights cannot be worked out through the corporation. If he is defrauded, let him sue directly the man who is guilty of the fraud.

Another consequence is that such a claim could not be prosecuted by a receiver of the corporation. It is in no sense the property of the corporation, which had no claim against the stockholders; nor would the personal right of a creditor vest in the receiver, although he, in a sense, is the representative of all the creditors. Even on the basis of the decisions of the United States courts, it is impossible to understand how a receiver of the corporation can enforce such a claim, for each creditor may be differently situated. Only those creditors who were ignorant and who relied are entitled to recover against the stockholder. The stockholder, therefore, has the right to defend against each creditor separately and to show that

that creditor could not have relied. If the suit is brought by a receiver of the corporation, this would be difficult, if not impossible.

The question next to be considered is whether an action for fraud furnishes any sounder basis than the trust fund theory for compelling a stockholder to pay more for his stock than he has agreed to pay. The question will first be considered on the understanding that when the courts say a creditor may recover on the ground of fraud, they are referring to a liability such as arises from fraud at common law.

One of the essential elements of a common law action for fraud is a false representation of a material fact. It must be remembered that the creditor of the corporation is seeking to recover from a stockholder. It must, therefore, appear that such *stockholder* has made the false representation. Now, it may very well be that all that the stockholder has done is to accept a certificate of full paid stock under an agreement with the corporation that he should pay nothing for it. The corporation may have held it out to the world that it has so much stock out-standing which, the courts say, the creditor has the right to presume has been or will be paid for in full. But how can it be said that the stockholder participates in such representation? It is not his representation, nor is it made by his agent. If made at all, it is probably made without his knowledge.

Another of the necessary elements of the action of fraud is that the defrauded party must have relied on the false representation. Under ordinary circumstances, as a matter of fact, at the time the credit was extended to the company, the person so giving credit did not even know that any particular individual was a stockholder. How then can he be said to rely on any representation made by him? The answer given to this question in the case of *Hospes v. Car Co.* (supra), is this:

> "Inasmuch as the capital of a corporation is the basis of its credit, its financial standing and reputation in the community has its source in, and is founded upon the amount of its professed and supposed capital, and everyone who deals with it does so upon the faith of that standing and reputation, although, as a matter of fact, he may have no personal knowledge of the amount of its professed capital, and in a majority of cases knows nothing about the shares of stock held by any particular stockholder, or, if so, what was paid for them. Hence, in a suit by such creditor against the holders of "bonus" stock, he could not truthfully allege, and could not affirmatively prove,

that he believed that the defendants' stock had been paid for, and that he gave the corporation credit on the faith of it, although, as a matter of fact, he actually gave the credit on the faith of the financial standing of the corporation, which was based upon its apparent and professed amount of capital. The misrepresentation as to the amount of capital would operate as a fraud on such a creditor as fully and effectually as if he had personal knowledge of the existence of the defendant's stock, and believed it to have been paid for when he gave the credit."

The court concludes that all that it is necessary for the plaintiff to show is that he is a subsequent creditor.

It has always been supposed that the plaintiff must plead and prove the facts constituting fraud. It is going a great way to say the least, when the court relieves him from making any proof and substitutes for it the knowledge of the court as to what gives a corporation a financial standing. Furthermore, the court's statement as to the source of the financial standing of a corporation may safely be challenged. A circular lies on the writer's desk saying that a corporation has outstanding full paid stock amounting to $1,500,000. Is there any business man who would be influenced to extend credit to that company on account of that fact alone? On the contrary, if an appeal be made to common knowledge, as the court has done, it will be found that the financial standing of a corporation depends upon the same facts as that of an individual. How much property has it and how much does it owe? Does it pay its debts promptly? It is believed that the amount of the capital stock affects the conclusion slightly, if at all. The court is going on very unsafe ground when it substitutes its own assumptions as to facts, for proof, as does the Illinois court in a similar case when it says: "They must have been influenced by it."

Melvin v. Lamar Ice Co. (80 Ill. 446).

But it may be said that the *Hospes* case was a suit in equity and was decided on equitable principles. But what principle of equity is there which will enable a plaintiff to recover under such circumstances? Perhaps it may be supposed that it is to be found in the statement in the opinion in the case that the stockholder must "Make that representation good by paying for his stock." There are certain circumstances under which courts of equity have been accustomed to compel a man to make his representations good. Mr. Pollock in his work on contracts *(Pollock on Contracts,* p. 497) after an extended discussion, reaches the conclusion that false representa-

tions produce legal consequences only when they can be considered as terms or conditions of a contract or when they operate as an estoppel, or when they amount to common law fraud, citing *Alderman v. Maddison* (5 Ex. D. 293).

Applying the learned author's conclusions to the case under discussion, it is clear that no representation which the stockholder may have made can be deemed to be a term or condition of the contract between the creditor and the corporation. Estoppel must stand on the same basis as common law fraud; if there is no representation and no reliance, there can be no estoppel or fraud. If Mr. Pollock is right, therefore, the present case furnishes no ground on which a court of equity can compel the supposed representations to be made good.

Of course, an exceptional case may arise where a creditor can show fraud or make out an estoppel. But such is not the ordinary case. To relieve the creditor, who best knows whether he has been misled or not, from the necessity of making any proof at all is an intolerable hardship on the stockholder.

The term fraud is used in courts of equity very freely and in many kinds of cases, but so far as the writer has been able to discover, none of those cases furnish any ground for a recovery in such a case as that under discussion.

The necessary conclusion is that there is no principle of law or equity on which a creditor of a corporation can compel a stockholder to pay more for his stock that he has agreed to pay. If such a result is to be brought about, it must be by virtue of some statutory regulation. Such is the conclusion of the New York Court of Appeals, in the case of *Christensen v. Eno* (106 N. Y. 97) which holds that a stockholder's liability arises from contract or statute; that unissued stock is not assets and that a person accepting shares as a gratuity has not injured the creditors or incurred a liability to pay the par value, contrary to his agreement, unless by reason of some statute.

Such also is the law of England where the courts hold not that such a stockholder incurs a common law liability, but that there is a statutory obligation on the one accepting a share of stock which cannot be varied by contract.

Ooregum Gold Min. Co. v. Roper (1892, H. L. App. Cas. 125).

This obligation may be inforced not merely by creditors but by the other shareholders.

Welton v. Saffery, L. R. H. L. 305 (1897).

The case of *New Haven Trust Co. v. Gaffney,* 73 Conn. 480, is to be sustained on this ground if at all. There the only agreement of the defendant was to pay 65 per cent. of the par value of the stock. In view of this express agreement, no other agreement can be "implied," or in other words inferred from the fact of acceptance of a certificate. The court is, therefore, mistaken when it says "The defendant, by taking the shares in question became, *under his contract of membership,* liable to pay $100" for each share.

The court also says that any contract by the company to issue shares at less than par was *ultra vires.* Unless the statute imposes on the one accepting a certificate of stock an obligation to pay par, the fact that the agreement to issue stock for less that par was ultra vires, instead of making the stockholder liable to pay par would relieve him from any liability at all. If the corporation is not bound by its contract because of lack of power to make it, the other party cannot be bound. The contract should be rescinded and the purchaser restored to his former position. It was so held in *Peter v. Union Mfg. Co.* (56 Ohio St. 181).

See also *Scoville v. Thayer* (105 U. S. 143).

But, if the effect of the statute is to impose a statutory obligation on the one accepting a stock certificate, then the case is in line with the English decisions and the corporation would have no power to vary the obligation. To release the stockholder from it would amount to giving away the assets of the company to the detriment of the other stockholders and in fraud of creditors. If the statute will bear such a construction, the case was correctly decided.

The liability of stockholders beyond their agreements, according to this view, becomes a matter for statutory regulation. It is the legislature that relieves stockholders from liability and it is for the legislature likewise to determine how far public policy requires that they should continue liable, apart from their actual agreements or frauds. There may be many valid grounds of public policy why par should be paid for every share of stock. In the view of the writer, however, the protection of creditors against the issue of watered or fictitious stock is not one of them, for such issue is no injury to corporate creditors.

Edwin S. Hunt.

Waterbury, Conn., Oct., 1902.